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The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Costa Rica

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SUMMARY

Between 1982 and 1987 the United States provided assistance of $953.1 million to support Costa Rica's economic development. The assistance included Development Assistance, PL 480 food aid, and Economic Support Fund (ESF) Cash Transfers. AU elements of the assistance package were designed to support Costa Rica's economic restructuring effort. However, ESF Cash Transfers of $730 million were the bulk of the aid package and were the mainstay of the Agency for International Development (A.I.D.) policy reform program. The evaluation focuses on those Cash Transfers.

In the 20 years prior to 1980, Costa Rica's economy had experienced some minor ups and downs, but had grown at a healthy pace. However, the doubling of oil prices in 1979 and the major worldwide recession that followed made major structural changes necessary. Government policies failed to face the new economic realities. Inappropriate prices, subsidies, and controls only made matters worse. The result was rampant inflation, rapidly falling gross domestic product (GDP),declining investment, and a major buildup of commercial foreign exchange debt.

A massive, multiyear Cash Transfer program (averaging 3.8 percent of GDP) helped lay the groundwork for change. A.I.D. worked closely with the International Monetary Fund (IMF) and the World Bank to gain agreement with the government on a long list of policy reforms. The government recognized the seriousness of the problems it faced and introduced a broad range of economic reforms.

Although some of the A.I.D.-recommended policy actions have not been taken, on balance the government put an appropriate set of policy incentives in place. The Costa Rican economy responded, and economic growth resumed at a modest but healthy pace.

BACKGROUND OF THE PROBLEM

Prior to the economic crisis of the early 1980s, Costa Rica was regarded as a model of economic development. Economic growth was strong, at 6 to 6.5 percent a year, and the benefits were equitably distributed. However, that growth concealed structural weaknesses that came sharply to light after the oil price shock of 1979-1980 and the subsequent worldwide recession.

The country was heavily dependent on a limited range of traditional agricultural exports. The small industrial sector produced goods for the highly protected Costa Rican market or nearby countries in the Central American Common Market (CACM), which also had highly protective common tariffs. The protective tariffs encouraged the growth of high-cost, inefficient industries. To make matters even worse, both the private industrial and agricultural sectors were unable to develop efficiently due to significant government intervention in the form of regulations, price controls, and subsidies. The large number of state-owned companies was a major drain on government resources, and the nationalized banking system exhibited a number of weaknesses in performing its role of financial intermediation.

Given these structural defects, the Costa Rican economy was unable to adjust to the international economic upheavals of the early 1980s. World markets for all four of the country's traditional agricultural exports (coffee, bananas, beef, and sugar) deteriorated sharply, while the price of imported oil doubled. The CACM virtually collapsed as other countries in the region suffered similar problems. With intra-CACM trade opportunities sharply reduced, Costa Rica's industrial sector lost the bulk of its export markets.

Rather than taking the necessary restructuring actions, Costa Rica initially tried to maintain its growth performance through heavy internal and external borrowing. A policy of rapid monetary expansion maintained existing levels of public and private consumption but caused inflation, an overvalued exchange rate, and a reduction of net foreign exchange reserves to negative levels. This policy was not sustainable. In July 1981, the government unilaterally suspended principal and interest payments on an external debt whose servicing requirements it could no longer meet.

Cut off from external financing, Costa Rica's economy rapidly deteriorated. GDP, which had grown by an average of 6 to 6.5 percent a year in the 1960s and 1970s, fell by an average of 4.8 percent in 1981 and 1982. By 1982 real per capita GDP was 14 percent below its 1980 level, open unemployment had reached 9.5 percent, and the inflation rate had soared above 100 percent.

A.I.D.'s ASSISTANCE APPROACH

A.I.D.'s general strategy was based on the four principal goals of the National Bipartisan Commission on Central America (the Kissinger Commission): (1) achieving economic stabilization, (2) laying the basis for long-term growth, (3) spreading the benefits of growth, and (4) strengthening democracy. Central to this strategy was the need to maximize the involvement of the private sector in the development process, allowing it to take the lead in fostering export-led growth and to achieve structural change through policy dialogue.

The success of Costa Rica, with its strong tradition of democracy and social justice, was important to the U.S. goal of establishing free, stable, democratic nations throughout Latin America. The country's dedication to democracy did not falter in the face of reduced living standards and the instability in neighboring Nicaragua. The social and political risks of a stagnant or even declining economy were contrary to U.S. interests in the region. In particular, with the turmoil in Nicaragua, it was important to prove that a country following a democratic, free market-oriented economic model could succeed. U.S. political interests could be achieved through a process of economic stabilization followed by sustained and broad-based economic growth.

A.I.D.'s policy reform efforts were based on a Cash Transfer program involving large amounts of highly flexible, quick-disbursing funds, designed to stabilize the economy and to support the major macroeconomic reforms essential to achieving sustainable long-run growth. A.I.D. assistance was provided in conjunction with assistance from the World Bank and the IMF. In almost every respect the three organizations worked closely together in a mutually supportive and comprehensive reform effort.

Central to A.I.D.'s strategy was the need to shift the Costa Rican economy from an emphasis on import substitution to one on export-led growth. A.I.D. policy reform efforts focused on removing constraints to private sector investment and private sector exports, particularly new, nontraditional exports. The final elements of the A.I.D. strategy concentrated on equity--the need to make sure that the process of restructuring also spread the benefits of growth to all segments of the population.

Prior to the economic crisis, U.S. assistance to Costa Rica was relatively modest, totaling only $13 million in 1981. In 1982, with the start of economic reform in Costa Rica, it jumped to $51 million, increasing to $212 million in 1983. While the assistance package included small amounts of Development Assistance and PL 480 food aid, roughly 75 percent was Cash Transfers. Cash Transfers were large relative to Costa Rica's population and economy. Costa Rica is a small country, about the size of West Virginia, with a population of only 2.7 million. From 1983 to 1987 Cash Transfers financed nearly 13 percent of Costa Rica's imports. On average, each year Cash Transfer resources represented 3.8 percent of GNP, reaching as high as 5 percent in 1983. On a per capita basis, they averaged $55 a year.

The Cash Transfer program was designed to meet short-term balance of payments needs while laying the groundwork for long-run, sustained economic growth. On the short-term side, Cash Transfers since 1983 have provided 12.8 percent of the foreign exchange needed to finance Costa Rica's imports.

The longer term objectives concentrated on major economic reforms and restructuring. Nearly half of the Cash Transfer covenants have been directed at the Costa Rican financial sector. Of these, most have encouraged the allocation of credit to the private sector and have tended to channel that credit through the small private banking sector. Covenants have supported the liberalization of the financial system by the deregulation of interest rates and banking activities.

Other reforms have included efforts to encourage the expansion of an export-oriented private sector. This has included specific export-promotion measures along with foreign exchange rate unification and privatization of parastatals.

A.I.D. POLICY REFORM MEASURES AND THEIR ECONOMIC IMPACT

Privatization

A large number of money-losing state enterprises owned by CODESA (a state-owned holding company) were running ever-increasing yearly losses, which were draining the Government budget. The Cash Transfer program facilitated a major divestment effort. State-owned firms are being sold to private investors or to employee cooperatives; if no buyers are interested, they are being dissolved. While the divestment effort got off to a slow start, by the time of this evaluation (October 1987), the first major state-owned firm (ALUNASA, an aluminum company) had been sold and the development pace was picking up as negotiations moved ahead on several other companies.

Export Promotion

Costa Rica needed to move beyond traditional agricultural exports (which had limited growth prospects) into new products for high-growth markets. This would include high-value agricultural crops and light manufactured goods for the U.S. and European markets. The Cash Transfer agreements included eight specific requirements designed to improve export incentives. CINDE, a private sector industrial promotion agency, was created as a condition of the first Cash Transfer program in 1982. CINDE has developed into an effective, private sector-controlled promoter of new investment and new exports.

Probably more important than direct export promotion has been the improvement in the overall macroeconomic policy environment. Cash Transfer conditionality provisions included changes that generated a unified foreign exchange rate that has remained internationally competitive through periodic mini-devaluations, market-based interest rates, removal of many price controls, removal of most limits and targets for credit allocation, and modest expansion of the small private banking sector. The private sector quickly responded to these new market incentives.

Particularly impressive has been the explosive growth of both agricultural and industrial export products, which were small or insignificant 8 years ago. This includes clothing and apparel and agricultural products such as ornamental plants, cut flowers, fruit (other than bananas), and spices. From 1982 to 1987 nontraditional exports increased from $167 million to $390 million, an 18.5 percent annual rate of growth. Even more impressive is the 29 percent annual increase in U.S. imports of manufactured goods from Costa Rica during the 1982-1987 period.

Foreign Exchange Rate Reform

From late 1980 through 1982 the exchange rate was greatly overvalued and multiple rates were often in effect. A.I.D. and IMF conditionality included measures designed to achieve a foreign exchange rate that more accurately reflected market conditions. After much vacillation, the government responded with a series of changes. By late 1983 most exchange restrictions were eliminated, and the unified rate was put on a crawling peg. The rate was based on a formula that related rates of inflation in Costa Rica with those of its major trading partners. Regular mini-devaluations took place, as often as every 2 or 3 weeks. The foreign exchange rate in the parallel or black market has kept close to that of the official market, a good indication that the official rate has been maintained at an appropriate level.

Public Sector Deficit

Between 1978 and 1981, there was a rapid increase in government expenditures, increased losses by state enterprises and national banks, and slow growth in tax revenues. Before the late 1970s, Costa Rica had a relatively good balance between public revenues and expenditures. But as economic difficulties began to mount, budget discipline collapsed. The deficit of the consolidated nonfinancial public sector increased from 9.0 percent of GDP in 1978 to 13.7 percent in 1981. In addition, with multiple foreign exchange rates, Central Bank losses increased to well over 5 percent of GDP. The total public sector deficit was nearing one-fifth of GDP, an unsustainable level.

In the first several years of the Cash Transfer program, A.I.D. relied on direct cross-conditionality with IMF agreements. Compliance with IMF fiscal and monetary reforms was a condition of the A.I.D. Cash Transfers. With the passage of the Kemp-Kasten Amendment (which restricted the direct linkage of U.S. assistance to the conditionality provisions of multilateral donors), however, Cash Transfer conditionality was made separate and independent.

Cash Transfer conditionality provisions required a reduction in Government expenditures and subsidies, an increase in revenues, and divestment of money-losing public sector corporations. The policy reforms generated a dramatic reduction in the deficit. The consolidated nonfinancial public sector deficit declined from 13.7 percent of GDP in 1981 to 4.5 percent in 1983. During 1984-1986 it declined further to only 1.7 percent. Central Bank losses are still significant, but they fell from 5.6 percent of GDP in 1982 to 3.8 percent in 1986.

Financial and Capital Markets

In the early 1980s, with a growing Government deficit, explosive inflation, and interest rate controls, real interest rates turned negative and private financial savings plummeted. By developing country standards, Costa Rica has a sophisticated financial system. The economy is highly monetized, and financial intermediation techniques are well developed. However, even a good system can be overwhelmed by economic crisis and inappropriate government policies. In mid-1982 real interest rates (nominal rates less inflation) were minus 40 percent and real (inflation-adjusted) private savings levels were shrinking at an annual rate of 20 percent. Much of the problem was due to government policies: regulated interest rate ceilings, subsidized rates for "special" borrowers, and credit ceilings, allocations, and controls. In addition to those controls, the state-owned banking system was very responsive to political credit priorities, even when such priorities made little economic sense.

As a result of A.I.D./IMF pressure, the Central Bank has steadily liberalized the financial system. Most nonmarket credit allocations (e.g., credit ceilings and allocative credit categories) have been replaced with more market-oriented mechanisms (e.g., changes in reserve requirements on bank deposits, open market operations and, most important, positive, market-determined interest rates). While some credit(less than 15 percent of the total) is still allocated by state-owned banks at subsidized rates, private and state-owned banks are now free to allocate credit and to set interest rates on most deposits and loans.

Probably the most important change that will have major, long-term benefits has been A.I.D.'s success in encouraging the Government to allow private banks to play a much greater role in financial markets. Previously the state-owned banks had almost a complete monopoly. Now, a growing number of private banks are offering a number of financial services. Private banks have proved to be more efficient, operating on a smaller spread (the difference between deposit and loan interest rates). The increased competition should improve the long-run efficiency of the financial markets.

A final success has been in bringing inflation under control. With the reduction in government deficits and the ending of an expansionary monetary policy, inflation rates have dropped from the triple-digit peak of 1982 to an annual average of less than 15 percent during the last 3 years. With inflation under control, and interest rates flexible, real interest rates have remained positive. This encourages both increased savings and more efficient investments.

Local Currency Programs

A.I.D. policy reform efforts can be supported by the use of local currency targeted at specific problem areas. The Cash Transfer program disburses dollars and results in the creation of an equivalent amount of local currency. The local currency is then used for projects and programs in support of the overall economic reform objectives of the Cash Transfer program.

Most local currency projects were private sector-oriented (42 percent of expenditures), and many of them supported export-oriented production. Local currency helped support an export promotion agency (CINDE), which has achieved significant success in promoting both foreign and domestic investment in non-traditional exports. Local currency funding also supported the divestiture of state-owned companies.

Another use of local currency was to promote agricultural development by supporting a new Agricultural School for the Humid Tropics. The evaluation team raised objections about the size of the project (24 percent of total local currency funding) and its low economic rate of return.

FINDINGS

Production and Private Sector Performance

While the pace has been slow, the privatization of government corporations and the encouragement of private banking have steadily strengthened the private sector and increased productivity. The creation of CINDE (an export promotion agency) generated new investment and jobs.

International Trade

Even with the deterioration of traditional export markets, Costa Rica's balance of trade has stabilized as a result of the rapid growth of new, nontraditional exports. The movement to a market-determined foreign exchange system is a major success. Success is not yet evident in the area of tariff reform, although some positive steps have been taken.

Fiscal Performance

The overall public sector deficit has come down sharply and is manageable. Government employment has declined only slightly, reflecting the political difficulty of implementing this particular economic reform.

Employment and Equity

Employment and social equity achievements were high to begin with, even by Latin American standards. It is fairly certain that they would have deteriorated significantly during the crisis of the early 1980s without substantial external support. Employment and wage indicators show a significant improvement since 1983.

Financial Performance

At the domestic level the private banking sector has grown, interest rates have been partially deregulated, and financial markets in general have been liberalized. All of these actions have helped to revitalize the private sector.

LESSONS LEARNED

Broad policy reform objectives should be translated into specific targets that can be monitored. The Cash Transfer program had a number of broad objectives designed to supporting-term structural adjustment. However, since there were few specific, quantitative targets, it was often hard to pin down exactly what reforms were being achieved and the degree of success. Missions should be as specific as possible in setting reform objectives and then demonstrate that each project and each condition has a short-term performance indicator and a termination date.

Policy reform deadlines should be realistic. While it is important to set deadlines for achieving objectives, they must be realistic. Many of the reforms (e.g., divestment, banking reform, deficit reduction) required difficult political and economic actions. The Cash Transfer agreements often assumed that they could be achieved in 12 to 18 months. They often took two or three times longer.

The number of local currency projects should be strictly limited. Local currency generations were applied to some 120 individual activities or projects. This large number of projects, covering a broad range of activities, placed an excessive management burden on the Mission. The evaluation recommended that the number of projects be strictly limited to 10 to 15 a year and that there be more discipline in the selection and design of local currency projects. Project-level documentation for larger projects should be similar to that required for regular A.I.D. dollar projects. Problems related to local currency ownership (who has legal, fiduciary, and program responsibility) and interest on deposits were identified as important issues, but they have since been addressed by A.I.D. worldwide policy guidance.

The development of local capacity for economic analysis is critical for sustainable policy reform actions. The Cash Transfer program was remarkably successful in achieving a number of policy reforms. However, policy reform is not a one-time effort. Next month, next year, or some time in the future Costa Rica will have to face other economic adjustments. It will need to know the economic costs of taking (or not taking) alternative policy actions. At this time that capacity is not fully developed, and most decisions are made on the basis of political considerations. Costa Rica needs to develop a stronger economic policy analysis capability within both the executive and legislative branches of the government. In order to sustain policy reform, A.I.D. should encourage the formation of such high-level economic analysis offices.

OUTSTANDING ISSUES

Debt Overhang

Costa Rica's balance of payments is well away from the cases of the early 1980s. However, export earnings and private capital flows are insufficient to finance all the imports Costa Rica needs to maintain present growth rates. The country is still dependent on donor assistance in order to fund a significant share of imports. Balance of payments self-sustainability is not in sight, mainly because of the need to service the enormous foreign debt that was built-up in the early 1980s. The debt remains a major burden, and periodic reschedulings and other forms of debt relief will be needed for the foreseeable future.

Dependency

In the early 1980s, Costa Rica's economy was a disaster. The Cash Transfer program deserves high marks for supporting a policy reform program that has put the country back on the development track. However, there is a nagging question of whether this effort will become self-sustaining.

Costa Rica is a small country, with a small population and a small economy. The annual Cash Transfers have been large in relation to population ($55 per capita), large in relation to GNP (peaked at 5 percent), and large in relation to imports (an average of 13 percent). Nor has this assistance been short term. A high level of Cash Transfers has been provided for 5 years running, and the World Bank and IMF have also been providing substantial resources.

Even though nontraditional export earnings are growing rapidly, the economy has grown accustomed to a substantial and continuing flow of concessional resources. All the major development signals (foreign exchange rate, interest rate, import-export price ratios, government budget deficit) are at a level that reflects a large and continuing assistance flow. If this flow continues for too long, longer term investment and allocative decisions will become distorted. The natural question is not whether but when Costa Rica can be weaned from its dependence on Cash Transfers.

A.I.D. Programming

In A.I.D.'s worldwide development approach, Cash Transfers are viewed as a highly flexible, quick-disbursing assistance tool. In the usual case, resources are provided to relieve a balance of payments crisis while policy reforms are being implemented.

In keeping with this short-term objective, Cash Transfers are usually not considered permanent elements of the A.I.D. portfolio. Although the problems and programs vary across countries, the program is generally treated as a transitional mechanism, providing a bridge to more specific sector or project assistance.

In Costa Rica, most of the major policy reforms are now successfully in place. With the strong growth in nontraditional exports and the reduction in the government deficit, the trade and budget gaps are both being narrowed.

In 1982 Costa Rica faced a severe balance of payments crisis and needed a policy reform overhaul. That is not the case now. A.I.D. should be moving toward a different type of assistance (sector or project assistance) to help Costa Rica prepare for the development problems it will face going into the 1990s.

This summary, by Joseph Lieberson, is based on an evaluation study of the Costa Rica Cash Transfer program. The study, which was sponsored by A.I.D.'s Center for Development Information and Evaluation, was completed in October 1987, and the judgments are based on data available at that time.

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